EATON CORP.'S TRANSFER PRICING TRIAL BEGINS AUGUST 24

Authors
Christine Long
Andrew P. Mitchel

Tags
Advance Pricing Agreement
Eaton Corp.
Puerto Rico
Transfer Pricing

The U.S. Tax Court's transfer pricing trial of *Eaton Corp. v. Comm'r*[1] will begin on August 24, 2015, despite attempts by the I.R.S. to further delay the trial until 2016. The controversy between the parties began in 2011, when the I.R.S. used its discretionary power to cancel its advance pricing agreements[2] with Eaton Corp. and issued a notice of deficiency. Eaton Corp. filed a petition in 2012 challenging the I.R.S. cancellations and claiming that the agreements should be upheld on the basis of contract principles. The outcome of the trial could have a substantial impact on the I.R.S. Advance Pricing Agreement Program and impact the finality of these agreements with other taxpayers.

The trial was originally scheduled to begin August 5, but the I.R.S. filed a motion to delay the trial for five months. In response to the motion, Judge Kathleen Kerrigan ordered a 19-day continuance. The I.R.S. filed another motion to reconsider the five-month delay, which Judge Kerrigan denied. The I.R.S. argued that Eaton Corp. has failed to cooperate during the discovery process and that it requires additional time to prepare for trial in light of new developments. Judge Kerrigan denied a further delay of the trial because she doubts that the hostile relationship between the parties will improve with additional time.

Eaton Corp. is the first taxpayer to contest the cancellation of an advance pricing agreement by the I.R.S. The case is a Code §936 restructuring issue that concerns companies with operations in Puerto Rico before the Code §936 credit began phasing-out in the year 2005. Code §936 restructuring cases generally focus on (i) whether the goodwill, going concern, and workforce-in-place values in Puerto Rican operations can be compensated for under Code §367(d) when transferred from the taxpayer's U.S. Code §936 corporation to a new foreign corporation; and (ii) the valuation of the taxpayer's transfer pricing methods between its U.S. entities and its new foreign corporation under Code §482.

Eaton Corp. and the I.R.S. entered into their original advance pricing agreement in 2000 for tax years 2001 to 2005. This agreement recognized Eaton Corp. as the distributor in the process of producing commercial and residential circuit breakers. The arrangement consisted of Eaton Corp. licensing technology to its Caribbean subsidiaries operating in Puerto Rico and the Dominican Republic to manufacture breaker products in exchange for royalty fees. The subsidiaries would then sell the manufactured breaker products to Eaton Corp. The advance pricing agreement established the best method for determining the arm's length rates under Code §482 for Eaton Corp.'s purchase of the breaker products. In 2005, the I.R.S. and Eaton

---

1 *Eaton Corp. v. Commr*, T.C., No. 5576-12.

2 An "advance pricing agreement" is an agreement between a taxpayer and the I.R.S. that determines the acceptable transfer pricing methodology for covered transactions in the years subject to the agreement.

Corp. renewed their advance pricing agreement to cover tax years 2006 to 2010.

In 2011, Eaton Corp. attempted to renew its advance pricing agreement again, but the I.R.S. claimed that Eaton Corp. failed to comply with the terms and conditions of the agreements and that it withheld information that would have prevented the I.R.S. from initially entering into the original agreement. The I.R.S. also contended that Eaton Corp. manipulated its transfer pricing methods and the company failed to implement a standard for accuracy. Eaton Corp. has adamantly denied it concealed information from the I.R.S. while negotiating the advanced pricing agreements and submitted responses to about 200 Information Document Requests during the negotiating process.

On December 16, 2011, the I.R.S. cancelled its advance pricing agreements with Eaton Corp. It issued Eaton Corp. a notice of deficiency and made adjustments to the transactions the company had with its subsidiaries in the Caribbean by applying an alternative transfer pricing method. Under Internal Revenue Code §§482 and 367(d), the I.R.S. adjusted Eaton Corp.'s income by $368.6 million in addition to tax and penalties for 2005 to 2006.

In February 2012, Eaton Corp. filed a petition with the Tax Court disputing the I.R.S.'s nearly $370 million proposed adjustment. The company claimed the advance pricing agreements were wrongly cancelled because the I.R.S. relied on one consultant's report, which failed to account for Eaton Corp.'s relationship with its subsidiaries, the sole owners of the manufacturing plants in Puerto Rico. Eaton Corp. has argued the deficiency notice erroneously calculated the amounts Eaton Corp. was required to pay its subsidiaries because the amounts were incorrectly based on the subsidiaries projections instead of their actual sales, which would have caused the manufacturing plants to pay unreasonable royalty rates. Furthermore, Eaton Corp. claimed it forfeited certain tax benefits for the purpose of entering into the advance pricing agreements with the I.R.S.

"The I.R.S. adjusted Eaton Corp.'s income by $368.6 million in addition to tax and penalties for 2005 to 2006."

ABUSE OF DISCRETION

The I.R.S.'s authority to cancel advance pricing agreements is based on revenue procedures that grant discretion to the I.R.S. Chief Counsel. Revenue Procedure 96-53[3] applied to Eaton Corp.'s original advance pricing agreement for tax years 2001 to 2005, while Revenue Procedure 2004-40[4] applied to Eaton Corp.'s renewed advance pricing agreement for tax years 2006 to 2010. Revenue Procedure 2006-09[5] is the current advance pricing agreement authority and is incorporated by reference into such agreement, in addition to the terms established in the agreement itself. At issue in the partial summary judgment motions filed by Eaton Corp. and the I.R.S. is whether the government abused its discretionary power in cancelling the advance pricing agreements.

In a June 2012 motion for partial summary judgment, Eaton Corp. contended the advance pricing agreements are binding agreements that should be enforced as "binding contracts." Eaton Corp. asserted that the Tax Court should apply contract principles to determine whether the I.R.S. had the right to cancel the agreements.

---

3 1996-2 C.B. 375.

4 2004-29 I.R.B. 50.

5 2006-1 C.B. 278, as modified by Rev. Proc. 2008-31, 2008-1 C.B. 1133.

The company acknowledged that the advance pricing agreements are not closing agreements under Code §7121, which are the only final agreements the I.R.S. executes, and are instead enforceable as contracts.

In its opposition to Eaton Corp.'s motion and cross-motion for partial summary judgment, the I.R.S. asserted that the burden should shift to Easton Corp. to prove the government abused its discretionary power in cancelling the advance pricing agreements. The Tax Court ruled that Eaton Corp. bears the burden of proving the government abused its discretion.

"Eaton Corp. is the only taxpayer to date to have challenged the cancellation of an advance pricing agreement by the I.R.S."

The outcome of *Eaton Corp. v. Commissioner* could significantly impact the I.R.S.'s advance pricing agreement process. If Eaton Corp. prevails, other companies are likely to follow suit. Eaton Corp. is the only taxpayer to date to have challenged the cancellation of an advance pricing agreement by the I.R.S. A success for Eaton Corp. could encourage taxpayers to continue entering into advance pricing agreements. On the other hand, if the I.R.S. prevails and advance pricing agreements are not found to be binding agreements, taxpayers may be deterred from entering into such agreements.